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6 February 1997

The Office of the Secretary
Federal Communications Commission
Room 222, 1919 M Street NW
Washington DC

Dear Secretary,

NOTICE OF PROPOSED RULEMAKING (FCC 96-484) ON INTERNATIONAL SETTLEMENT RATES

I attach an original and nine copies of the United Kingdom Government's comments on the proposed rulemaking on international settlement rates.

Yours faithfully

Pat Phillips

Pat Phillips
First Secretary, Trade Policy

cc: Ms K O'Brien, International Bureau, FCC
Room 822, 2000 M Street NW

International Transcription Services,
2100 M Street NW, Suite 140

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OFFICE OF SECRETARY

UK COMMENTS ON NOTICE OF PROPOSED RULEMAKING (FCC 96-484) ON INTERNATIONAL SETTLEMENT RATES

Introduction

The UK Government considers the FCC's overall ideas on benchmarking a useful contribution to creating new impetus to the internationally agreed objective of making accounting rates more closely reflect the cost of the telecommunication service provided. The UK will wish to support the US in discussion of benchmarking or other methods of creating greater momentum for rapid cost-orientation of accounting rates as agreed in ITU Recommendation D.140. It believes, with the rapid introduction of facilities-based international competition on the major markets of the world (EU, US, Japan and Canada make up around 85% of world trade in telecoms), that for the bulk of world traffic accounting rates will with time be replaced by self termination or new commercial arrangements based more closely on domestic interconnection costs.

2 This development will also have an impact on routes where accounting rates remain. Increased competition, and the relaxation of regulation on accounting rates (e.g. proportionate return, parallel (uniform) settlement rates) as implemented in the UK in the 44 new facilities-based international licences issued on 20 December and similar relaxation of the Commission's International Settlement Policy proposed under the FCC's Flexibility Order, will create strong downward pressure on collection rates. This will make for much lower margins on international consumer tariffs, and create commercial pressures on operators in competitive markets to obtain lower accounting rates on all routes where these are retained.

3 Against this background, the UK offers the comments set out below.

Alternatives to accounting rates

4 As described in paragraph 1 above, the UK believes that, on competitive routes, accounting rates will over time be replaced with more flexible commercial interconnection arrangements. Para 17 (p.8) of the present NPRM solicits comments on alternative approaches to reforming accounting rates. Para 20 (p.9) of the NPRM states (and the UK fully agrees) that "the most effective way to ensure settlement rate reform that results in reasonable international calling prices is through the development of competitive markets for IMTS". Para 69(p. 27) of the NPRM seeks comments on whether the FCC should forbear from applying benchmarks to competitive routes.

5 On these points, the UK believes that countries with competitive markets should seek to encourage the introduction of competition worldwide, and do so by their example. This means, inevitably, weighing up on the one hand the legitimate concerns of incumbent operators to avoid abuse by competitors in less competitive markets with, on the other, the economic and consumer benefits derived from minimising barriers to market entry and competition. This also means avoiding the perpetuation of cartellised consumer pricing which rigid controls on accounting rate traffic aimed at preventing abuse by foreign monopolies tend to encourage.

6 We therefore believe that regulators should concentrate on measures which lead to the reduction of the collection rate (ie the tariff actually charged to consumers), and that any new approach to settlement rates should bear that consideration in mind. The rigidities of the present accounting rate system, and of the safeguards necessary to prevent abusive by-pass of that system, also tend to create distortions of the market themselves. Parallel accounting dampens price competition, proportionate return leads to regulation, rather than consumer price competition, driving operators' decisions on how to generate market share. (An example of this is the high levels of discount - anecdotally up to 75% below published tariff and often below the settlement rate - offered by US carriers to callback operators. This only makes commercial sense as it generates return traffic which the operators would otherwise not receive under the present International Settlement Rules).

7 <u>The UK therefore believes that, in respect of the question posed in para 69(p.27) of the NPRM, on routes where competition allows US operators to terminate their own traffic at local interconnect prices, the Commission should remove benchmark regulation, which might otherwise hinder the market in bringing termination down to cost.</u> We note that, on a number of routes, the benchmark is already above the actual settlement rate, and use of the benchmark would at best be ineffective, and at worst tend to act as an upward target for negotiations of what should otherwise be commercially-set rates. Competition must be the preferred mechanism for reducing rates to economically efficient levels.

8 In the UK, we have already allowed operators the freedom on the largest traffic routes to terminate their own traffic in the UK, and to negotiate any other commercially attractive arrangements as an alternative to accounting rates. This freedom at present applies to the six routes previously found equivalent for ISR and all the (other) countries of the European Economic Area. Currently, routes which have not been found competitive are subject immediately to specific measures to prevent one-way bypass and anti-competitive manipulation of accounting rates (including proportionate return, parallel accounting, and licence conditions governing anti-competitive behaviour). On competitive routes these rules can be invoked if such distortion arises after the event. (These rules will be aligned by the UK for all countries if there is a WTO agreement on basic telecommunications.) Application of similar measures already at the disposal of US regulators and anti-trust authorities may provide additional safeguards to US operators.

9 It is worth making a general point on the use of such powers. Regulators in some countries can be pressurised by incumbent operators in the international market to introduce restrictions to create "level playing-fields" for incumbents, but which can actually represent a barrier to competitive entry serving only the interests of those incumbent operators. In the UK, we have had most of the licence conditions mentioned in para 8 above in place since 1992 in ISR operators' licences, but have not felt it necessary to use them once. This, we believe, shows that many of the more alarming potential abusive practices attributed to foreign operators do not materialise. Regulators should therefore be wary of placing too much emphasis on producer interests alone. Not least as a function of their incumbent position, existing operators demonstrate a remarkable ability to meet challenges from new entrants.

<u>Implementation of benchmarking proposals</u>

10 The UK will not offer detailed comments on the methodology used to calculate the benchmarks in the NPRM. We note the difficulties which the Commission has had in obtaining detailed cost data and interconnection prices for most of the routes examined (para 42, p.18 of the NPRM), and the NPRM's recognition of the inevitable approximation of costs possible under the proposed approach. Para 55 (p. 23) of the NPRM requests comment on whether it is preferable to set benchmarks on a country-specific basis or as an average for an economic group of countries. While having no strong views on this question, the UK would share the view in Para 46 (p.20) of the NPRM that an averaging approach could diminish the ability of an individual carrier seeking to affect the level of the benchmark for its country by setting an inflated published local tariff. But there might be a need to look at the possibility that a particular grouping with a preponderance of monopoly suppliers might still seek to affect the level of the benchmark by collectively altering their rates upwards.

11. We would offer some views on how best to implement these proposals. We share the FCC's analysis of the difficulties related to high accounting rates and believe (see paras 1-2 above) that increased competition will squeeze operators' profit margins and affect their ability to pay such inflated rates. The NPRM (para 25, p.11) recognises the adjustments that such benchmarked accounting rates will require in many developing countries who use the foreign capital inflows from international traffic as source of capital for investment in network infrastructure. This has, as para 25 notes, an effect on developed countries' operators and manufactures as well. Better network infrastructure in the developing world provides a stimulus for traffic on the route concerned, both by creating a larger destination market, but also allowing better delivery of advanced services requiring sophisticated network

equipment. This creates higher revenue for all operators serving the route. Such investment in turn creates new demand for network equipment, almost without exception sourced from manufacturers in the developed world.

12. The NPRM therefore rightly recognises the need to persuade developing countries that lower accounting rates will benefit them, and that some countries may need more time (NPRM paras 43ff) than others to adjust. The ability, ultimately, to impose an accounting rate will no doubt help US operators in negotiating lower rates themselves, but they may also need to overcome potential difficulties with correspondents in the application of the measures proposed, on which the FCC may be able to help. Para 65 (p.26) of the NPRM asks for any alternatives to transition periods. One potential method of offering developing countries some staging of reductions might be to maintain settlement rates for existing traffic at the present level, while requiring incremental traffic to be charged at a lower level to ensure that the outpayment deficit did not grow with increases in traffic. This might be combined with the transitional phasing in of overall lower rates to give further flexibility.

Possible incentives for developing countries' carriers

13. It is very hard to calculate reliably the price elasticity of international traffic, particularly where this market continues to grow at between 10-15% annually worldwide. It is, however, clear (para 10, p.5 of the NPRM) that such elasticity is present in the market, and that reduced consumer tariffs will stimulate new traffic.

14. One useful incentive which could be offered to foreign carriers to reduce their settlement rate (and thus, if they have an inbound surplus, as they might see it, forego substantial revenue to the sole benefit of the operator in the developed market) is to accompany such a reduction with measures aimed at increasing outbound traffic on the route. In the past, this has been unwelcome to US operators as it would increase outpayments against a high accounting rate. If, however, such a growth is based on a rate reflecting cost much more accurately, any imbalance arising should not in principle cause concern. Para 9 (p.5) of the NPRM shows the average US international tariff at 99c/min. Para 26 (p.11) notes the average US settlement rate as 35.6c/min. Developing countries might question whether, with a margin of some 175% between settlement and collection rates, a unilateral reduction on their part would in fact impact very strongly on the output price to the US consumer. They might also point to the $5bn. outpayment by the US operators making up less than 10% of the $60bn international traffic turnover of US operators and ask whether the accounting rates they demand have been the primary cause of diminished consumer benefit and high collection rates in the US.

15. In Para 91(p.35) of the NPRM, the Commission seeks comment on ways of encouraging US carriers to reflect the reductions they receive in settlement rates. One way, which would also perhaps meet developing countries concerns would be for the FCC to seek some undertaking from US long-distance operators on a reduction in collection rates in return for closer-to-cost settlement. This, along with other commercial measures, such as special promotions or offers would stimulate traffic on the route concerned, and create some compensating revenue for the foreign correspondent. US operators would still have the assurance under the benchmarking approach that they would be paying a 'real' rate for the termination of the new traffic they generate. It would, of course, also give US consumers some assurance that they would see these savings on per minute outpayments passed on to them in lower collection rates. But the best way of achieving reductions in collection rates in the US must be to allow as much competition in the international market as possible from carriers both within and from outside the US. In a more competitive multi-carrier environment where open access to networks is available on cost based terms, price leadership is more difficult to maintain, it is more likely that operators will pass on savings on settlement rates to customers.

16. Another element of concern often expressed by developing countries is callback (dealt with in para 12, p.6 of the NPRM and footnote on same page). The UK has resisted calls in the ITU (most

recently in the ITU Standardisation Conference in Geneva in 1996) for a general outlawing of call-back, which results, in many (but not all) cases, from the very high international collection rates in the countries involved. As discussed briefly in para 6 above, there are reported cases of US carriers offering considerable discounts below the settlement rate on certain routes. The use on as many routes as possible of the opportunities offered to carriers under the FCC's Flexibility Order to depart from ex ante imposition of proportionate return would remove some of the distortive effect of the present ISP in encouraging operators to gain return traffic at any cost and would, without reducing pressure on foreign collection rates which were out of line with those of the US or other developed countries, create a slightly more 'real' wholesale market for call-back.

Other issues

17. Paragraph 80 (p.31) of the NPRM asks whether the Commission should use benchmarking as a safeguard against cross-subsidy and anti-competitive behaviour. As discussed in paras 8-9 above, the UK believes that some safeguards are necessary to avoid anti-competitive behaviour. The question of whether the existence of high settlement rates provides an incentive to cross-subsidise a US affiliate perhaps needs some precision. The activity in question is more likely, if it occurs at all, to involve the ability of a foreign carrier terminating its own traffic to charge its affiliate for termination of its traffic at no or much lower charge than the settlement rate. A cross-subsidy in itself is not necessarily an anti-competitive act, as most start-up activities will involve the carrying of initial losses by a parent, as has happened in the UK with a number of US companies. Presumably the FCC will not wish to be obliged to impose such constraints on new entrants who have no dominance in the US market. Thus the important distinction to be made is perhaps between an operator seeking to self-terminate traffic on a route on the one hand where there are a number of operators able to self-terminate, and on the other, on a route where there is a monopoly for international services at the far end. In the latter case, there is the theoretical danger of the far-end operator attempting to maintain high settlement rates, while bypassing the accounting rate in the US, and some safeguard is necessary as discussed above. Where there is liberalised licensing of international operators at the far end, any operator seeking to maintain high accounting rates will see its correspondents either set up their own self-termination arrangements or drift towards others who may charge a lower rate. Thus, self-termination should be encouraged as widely as possible as a potent method of bringing down accounting rates.

18. As to whether foreign operators seeking to maintain high accounting rates actually will seek to bypass an accounting rate system which they are, it must be assumed trying to maintain, we believe that such operators are likely to wish to avoid anything to upset the status quo. To divert traffic to the US onto alternative means and thus exploit lower termination arrangements in the US would invite retaliation (given some force by the benchmarking approach) from US carriers and result in the very thing they are presumably seeking to avoid - an imposed, and drastically lower accounting rate. The benchmarking approach will in itself provide a powerful deterrent to such behaviour.

19. The NPRM (para 78, page 30 and footnote) proposes to include in licences granted to foreign carriers a condition requiring those carriers to apply the benchmark rates to their "affiliated route". Later in the same paragraph, the NPRM states that "all US carriers would receive the same settlement rate for traffic". We presume that this means that all US carriers on any route would be treated the same, regardless of affiliation on the settlement they both pay and receive on any route, and that such a licence condition would only be significant if the route in question had not yet reached the benchmark target. It might be helpful for this, and the statement in the relevant footnote (footnote 76) that this would not act as a barrier to market entry, (assuming the potential licensee agrees such a condition), to be clarified in the final Order.

20. We note also in para 82 (p.32) of the NPRM the proposal to allow ISR on routes where the benchmarking targets have been broadly achieved. This is, we believe, a sensible extension of opportunities to bring down US consumer tariffs beyond the restricted number of countries found equivalent under the FCC Resale Order. We would urge the Commission to consider extending the ability to provide ISR services to as many routes as possible, given the useful role that ISR can play in putting pressure on collection rates, and in turn on the settlement rate. This would point to extending the policy also to routes where the benchmark has not yet been reached, provided that other safeguards against one-way bypass are in place (see para 8 above for brief description of UK approach). In applying this policy the FCC will no doubt also wish to consider its implementation against any agreement reached in the context of the World Trade organisation on basic telecommunications.

Conclusion

21 Overall, the UK welcomes the NPRM. It would urge the Commission however, to ensure that implementation of the proposals set out in the document to aim at reducing collection rates in the US and in foreign countries to produce equal gains to consumers and carriers. It believes that the policy should be applied in a way which can take account of the needs of the developing countries, and the role of network development in these countries in increasing the size of the global market for all players. The phasing-in of benchmarks is helpful in this, but should be supplemented in other ways to ease the building an international consensus in the ITU and elsewhere to move towards those lower settlement and collection rates, and the UK would wish to support such efforts.

22 The UK would finally wish to underline its view that the problems associated with the present accounting rate system would be best resolved by commercial agreements driven by the real cost of interconnection. In markets where competition allows freedom to provide transmission and switching for international traffic, carriers will have a choice of building their own capacity and presenting traffic for interconnection at the same rate as domestic rates, or reaching agreement with another carrier to deliver and interconnect such traffic based on the opportunity cost of building its own capacity. In markets where this is not yet possible, we believe that accounting rates should be encouraged rapidly to approach cost, and that ideally those markets should open themselves to competition. Regulatory changes in a large number of countries, both developed and developing, point towards this already happening. In drawing up rules on accounting rates as proposed in the NPRM, the FCC should take care to avoid creating new and complicated regulation which might slow down or hinder the replacement of accounting rates by such alternative arrangements, and the full exploitation of competitive opportunities to lower the cost of international services to consumers.

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